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Financial services and consumer protection after the crisis

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ABSTRACT

Purpose- The purpose of this paper is to examine the approaches to consumer protection in UK financial services before and after the global financial crisis.

Design/methodology/approach- This paper reviews the literature on Behavioural economics and Psychology, and uses it as the basis for a critique of the UK's approach to the supervision of financial services firms and the protection of their consumers.

Findings- Non-interventionist approaches to consumer protection, which are based on the traditional theories of the Law and Economics movement, have failed. As a result, there is now a shift in thinking towards more interventionist approaches.

Research limitations/implications- By understanding the likely impact of the regulatory reforms the academic research community can assist the regulator to understand the best way to ensure desirable outcomes for users (consumers) of financial services.

Originality/value- The moves to reform UK financial regulation after the crisis have only recently gotten underway and a lot of the reforms have not been widely debated or written on.

Keywords consumer protection, Rational Choice Theory, intensive supervision

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INTRODUCTION

The global financial crisis of 2007-2009 is, arguably, the most significant financial crisis to occur since the Great Crash of 1929, which led to the Great Depression. The crisis of 2007-2009 was caused by a number of factors for example flawed monetary policy, excessive and uncontrolled use of financial innovation, the proliferation of shadow banking activities and inadequate corporate governance structures within banks and other financial services firms (Avgouleas, 2009). To a large extent, it was also a manifestation of regulators' failure to maintain the overall stability of the financial system. Apart from this failure to maintain systemic stability, there were also some failures to protect consumers, for example regulators' approaches to the supervision of financial firms were not assertive enough thus resulting in a situation where a large number of borrowers are struggling to pay back mortgages as a result of irresponsible lending.

Apart from this there have been other examples of financial practitioners acting in a way that was detrimental to consumers, for example the scandals arising from the mis-selling of retail financial products such as personal pensions and endowment mortgages (Gray, 2004). Such incidents illustrate how firms and practitioners in the financial services industry are able to exploit an unfair advantage they have over their consumers (investors) in terms of superior information and expertise. Such opportunistic behaviour, arguably, indicates the need for tighter regulation of financial services.

This article looks at some of the principal theories on why we intervene, in markets, to protect consumers. It also looks at how the financial crisis has led to a re-thinking of how this might be done. In so doing, it examines the regulatory philosophies that underpinned consumer protection regulation in UK financial services before the crisis, as well as the new ideas that might replace them in the new post-crisis era.

APPROACHES TO CONSUMER PROTECTION REGULATION

The government or regulator tasked with consumer protection will often have to balance the interests of consumers on the one hand with those of the sellers or suppliers on the other hand. To this extent, its approaches to consumer protection regulation will be interventionist, non-interventionist or a mixture of both. The non-interventionist and interventionist approaches to consumer protection will now be discussed in turn.

Non-interventionist approaches

Non-interventionist approaches emphasize allowing the consumers and sellers the freedom to make bargains and contracts without external interference from government or regulators. The non-interventionist approaches are promotion of competition (between the different suppliers or sellers) (Yeung, 2004), the use of information disclosure (Howells, 2005), the use of *caveat emptor* (Mcmeel and Virgo, 2001) and the reliance on private enforcement mechanisms (Polinsky and Shavell, 2000, Shavell, 1993, Van Den Bergh, 2008).

The ‘Chicago School’ of economic thought has traditionally been a supporter of non-interventionist approaches. Their arguments are based on a deep-seated belief in the

efficacy of the free market as a means of organising or allocating resources (Friedman, 1974). They are also founded on a great deal of scepticism of government intervention in economic affairs (Friedman, 1974). The argument is that in the absence of government intervention the free market functions at least as well as, and probably better than, any other type of economic arrangement (Friedman and Friedman, 2002) ((Wall, 1972). The reason for this, according to Chicagoans, is that voluntary exchange is the most efficient method of allocating resources, promoting individual choice and preserving political freedoms (Friedman and Friedman, 2002).

This belief in free markets, minimal government and the promotion of private enterprise is, in turn, founded on the proposition that human beings maximise their own self-interests and are therefore rational economic creatures (Stigler, 1982). This is known as Rational Choice Theory. Rational Choice Theory is, in many ways, the foundation for the law and economics movement (Jacoby, 2000). It is based on the premise that human beings are maximisers of their satisfaction, or utility, and that when faced with a set of choices, will always pick the option that they believe maximises their satisfaction or utility (Becker, 1978, Posner, 1990). This premise is, in turn, based on the assumption that when making choices people have adequate information (to aid them in making those choices) and the ability to properly process that information (Ogus, 1994). Consequently individual choice must be preserved, while limiting external or government interference (in individual's decision-making about their welfare) to the improvement of information flows (Ogus, 1994). Rational Choice Theory, therefore, seems to argue for limited, if any, regulation or other government intervention, since individuals know how to maximise their utility and are capable of doing so.

A major criticism of non-interventionist approaches arises from a significant defect of Rational Choice Theory. This criticism can be found in the Behavioural Economics and Psychology literature. The problem with Rational Choice Theory is that people do not always make rational choices. Individuals can, and do, make inferior decisions with regards to their welfare- decisions that they would not have made if they had complete information, unlimited cognitive abilities and unlimited self-control (Jolls et al., 1998). This arises because people often use heuristics (rules of thumb) which are aimed at making complex tasks, of assessing probabilities and predicting values, simpler, but which can sometimes lead to severe and systematic errors (Avgouleas, 2008). There is a wealth of empirical studies, in both Behavioural Economics and Psychology, that show that the use of heuristics, such as the availability heuristic (Slovic, 2000) and the affect heuristic (Slovic et al., 2004), results in cognitive biases (cognitive weaknesses) in individuals' decision-making, which, in turn, lead them to make systematic errors (Tversky and Kahneman, 1974). Some examples of cognitive biases are overconfidence (Shiller, 2000), probability neglect (Sunstein, 2005) and loss aversion (Kahneman and Tversky, 1979, Kahneman et al., 1990, Kahneman and Knetsch, 1991). Individuals, thus, suffer from bounded rationality (Jolls et al., 1998, Simon, 1955), bounded self-control (Frederick et al., 2002, Jolls et al., 1998) and the effect of framing (Camerer, 2000, Johnson et al., 2000) when making choices regarding their welfare.

Interventionist approaches

Interventionist approaches to consumer protection are characterised by the greater involvement of government or regulators in the monitoring of suppliers and sellers of

goods and services in a bid to protect the interests of consumers. Typical interventionist approaches include bans and regulation, altering the default rules and risk-sharing (Howells, 2005). Interventionist approaches in financial services include conduct of business regulation and product regulation.

A significant justification for interventionist approaches comes from the extensive scholarly empirical literature on the behaviour of individual consumers, which concludes that Rational Choice Theory is a simplistic theory that has little correspondence with the real world (Jacoby, 2000, Jacoby et al., 1998, Peter and Olson, 2008). Human behaviour is a complex function of many known and unknown factors, and although economic variables play an important role in our choices, there are many other variables which also play a role in our choices, for example psychological, sociological, cultural and environmental variables (Jacoby, 2000). The upshot of this is that the application of Rational Choice Theory will not work for all markets and all consumers all of the time or in all situations (Jacoby, 2000).

Another significant justification for interventionist approaches to consumer protection is information inadequacy. Information is necessary in order for markets to function properly- for a market to function well buyers must have enough information to help them evaluate products (Hayek, 1945), and there should be as much information available as consumers are willing to pay for in order to improve the quality of their choices (Breyer, 1982). This is, however, not always the case, for a number of reasons.

The first of these reasons is that information is sometimes expensive to produce and difficult to restrict to only those who pay (Breyer, 1982), therefore there is less of an incentive to produce such information (Asch, 1988). This can lead to the production of inadequate or too little information (Sunstein, 1990), and thus constitutes an argument in favour of regulation.

The second reason is that one of the parties to a transaction may deliberately try to mislead or deceive the other party, by conveying false information or omitting important facts- the fact that individual consumers will often have incomplete information, coupled with the significant costs involved in determining the quality of a particular good or service, create favourable conditions for fraud to take place (Darby and Karni, 1973). Although there are other ways of dealing with this particular problem, for example service contracts, leasing arrangements, extensive warranties, client relationships and branding (Darby and Karni, 1973), regulation should not be ruled out.

The third reason is that even if the necessary information is provided the buyer may be unable to evaluate all the characteristics of the products or services on offer, for example a lay man cannot readily evaluate the competence of a doctor or lawyer (Breyer, 1982). The result of such information asymmetries between buyers and sellers (where the sellers have more knowledge about the quality of the goods on sale than the buyer) is often described as a “market for lemons” (Akerlof, 1970). In a market for lemons there is an incentive for sellers to market poor quality merchandise because the returns for good quality accrue to all sellers rather than to the individual seller (Akerlof, 1970). The market will, therefore, supply quality at inefficiently low

levels (Cheffins, 1997). Although there are other ways of dealing with the market for lemons (that is, the effects of quality uncertainty) for example the use of guarantees and brand-names, there is still a strong case for licensing and other forms of regulation, in order to increase the welfare of all parties (Akerlof, 1970).

The problem of quality uncertainty is particularly relevant with regards to experience goods rather than search goods (Nelson, 1970). With search goods there is less danger the buyer will make incorrect purchase decisions because the relevant characteristics can be known prior to purchase, whereas with experience goods there is a greater likelihood of unsuitable purchases because the relevant characteristics will often only be ascertainable after purchase and use (Breyer, 1982). The problem of quality uncertainty is also relevant with regard to credence goods because it is difficult to ascertain their characteristics or their quality even after they have been used or consumed. The problem of quality uncertainty is, therefore, particularly relevant to banking and other financial services because long-term savings and investment products tend to be credence goods rather than search or experience goods. The problem of quality uncertainty thus contributes positively to the argument in favour of regulation.

The fourth reason why there might be inadequate information in a market is that the market may simply not be competitive enough to provide all the information that consumers would be willing to pay for, for example until the US government mandated disclosure, accurate information was unavailable, to most buyers, regarding the fuel economy for cars, durability of light bulbs, nicotine content of cigarettes or care requirements for textiles (Breyer, 1982).

Having looked at the four reasons it is clear that information inadequacy poses a very strong justification for regulation. By making information more extensively available, accurate and affordable, regulation can protect buyers against the adverse consequences of information inadequacy thus encouraging the operation of healthy markets (Baldwin and Cave, 1999). To this extent regulation is a desirable thing.

Morality presents another justification for interventionist approaches to consumer protection. This is because capitalism itself encourages the baser human motives such as self-interest and the desire for personal profit, while at the same time discouraging the more traditional moral virtues such as honesty, integrity, self-sacrifice and the charitable instinct (Barry, 1991). Thus, if an unregulated market is likely to produce self-serving conduct which breaches widely accepted standards of morality, then there could be an argument made for the introduction of regulation into such a market (Cheffins, 1997).

In attempting to curb conduct that breaches widely accepted standards of morality, regulation can also promote confidence in the market, since unethical or improper conduct is precisely the thing that undermines public confidence in the market (Barry, 1991, Cheffins, 1997). Morality thus provides a good justification for regulation.

A further justification for interventionist approaches is paternalism. It is largely based on the weaknesses of Rational Choice Theory. The perceived inability of individuals to make correct choices with regards to their welfare is a justification for regulation that is paternalistic in nature- such regulation is based, largely, on the belief that the

market is unable to regulate itself in a particular area of social or economic activity, thus requiring government initiatives that are interventionist in nature (Avgouleas, 2005). Paternalism itself has been defined as “the interference with a person’s liberty of action justified by reasons referring exclusively to the welfare, good, happiness, needs, interests or values of the person being coerced” (Dworkin, 1971, Ogus, 2010, Van De Veer, 1986). It is a powerful justification for regulation, even when other justifications, such as externalities, are also appropriate (Ogus, 1994), and it has even been argued that, very often paternalism is inevitable (Sunstein and Thaler, 2003).

The problem with paternalism is that it is viewed by some, especially libertarians, as coercive, restrictive on choice and freedom and it blurs the boundaries of state intervention (Friedman and Friedman, 2002, Hayek, 1960, Hayek, 1973, Nozick, 1974). To overcome the criticisms of paternalism, Sunstein and Thaler have come up with the idea of libertarian paternalism (Sunstein and Thaler, 2003). They argue that arguments against paternalism are based on a false assumption (that people always make choices that are in their best interests) and misconceptions that there are viable alternatives to paternalism and that paternalism always involves coercion (O’donoghue and Rabin, 2003, Sunstein and Thaler, 2003). Libertarian paternalism is a fairly weak and non-intrusive version of paternalism, whereby choices are not blocked but planners self-consciously attempt to move people in welfare-promoting directions (Sunstein and Thaler, 2003), thus making the regime both libertarian and paternalistic at the same time.

A good look at some of the things that paternalistic regulation has been put in place to avoid, for example under-aged smoking and drinking and the failure to wear seatbelts

(Dworkin, 1971), makes it clear to us that individuals, if left to their own devices, do not always make rational decisions or welfare-maximising choices. This therefore counts as a good justification for intervention in order to ensure their welfare.

CONSUMER PROTECTION IN THE FINANCIAL INDUSTRY BEFORE THE CRISIS

The Regulatory Objectives

UK financial regulation in the run-up to the financial crisis was (and remains) a mixture of both interventionist and non-interventionist approaches. The UK financial regulator, the FSA, has four statutory objectives (which can be found in the Financial Services and Markets Act 2000 (FSMA)) and these are the protection of consumers (of financial products and services), maintaining confidence in the financial system, reducing financial crime and promoting public understanding of the financial system (FSMA sections 2(2) and 3). Consumer protection is therefore one of the main aims of UK financial services regulation, and the regime contains measures aimed at ensuring consumers have adequate protection when dealing with financial services providers (FSMA Parts 15 and 16). The fact that consumer protection is explicitly outlined as one of the regulatory objectives makes it one of the central aims of the regime and this is definitely desirable.

The multiple objectives of the regulator could, however, be problematic, since there is the potential for confusion with regards to how to prioritise the different objectives. Some statutes set out objectives that are mutually at odds with each other, and achieving one of such objectives may necessarily involve trading off performance in relation to other stated objectives (Baldwin and Cave, 1999). Regulatory scholars

often fail to pay enough attention to the ideological differences which underpin law or regulation, because rather than focus on the differences between regulatory goals they focus on the differences between compliance strategies (Haines and Gurney, 2003).

The FSA's stated objectives might not initially appear to be mutually at odds with each other, but on a closer examination, it is possible to observe subtle, but significant ideological and policy differences among some of its objectives. The potential for conflict between its goal of protecting consumers and its goal of educating consumers (promoting public understanding of the financial system) provides a good illustration of this. The statutory objective of protecting consumers reflects the idea that regulation should protect consumers because of information asymmetry, the fact that individuals do not always make rational choices (the failures of Rational Choice Theory) and the fact that unregulated markets are likely to produce self-serving conduct which breaches acceptable standards of morality. This is essentially an interventionist approach based on the traditional justifications for using interventionist approaches. This provision for consumer protection can be contrasted with two other provisions in the statute. The first of these is a proviso to the consumer protection objective, which states that consumers must accept personal responsibility for their decisions (FSMA section 5(2)(d)). The second is the statutory objective of promoting public understanding of the financial system, which is premised on the idea that if consumers can be 'educated' they can be empowered, and will thus be able to look after their own interests, thereby reducing the need for interventionist approaches to consumer protection (FSMA sections 2(2)(b) and 4). It is based on Rational Choice Theory and incorporates non-interventionist approaches such as information disclosure and *caveat emptor*.

There is a strong argument for caution when using information disclosure to make consumers responsible for their decisions, since the effectiveness of information disclosure as a regulatory technique to empower consumers may be limited (Gray and Hamilton, 2006). *Caveat emptor* is also problematic because it amounts, in effect, to abandoning consumers to their fate. It is, therefore, suggested that when a decision is being made about which objective to give priority to, the regulator should give the consumer protection objective priority over the objective of promoting public understanding of the financial system.

Supervision of the financial services industry

The supervision of the financial services industry has, to date, been based on a number of key ideas. These are risk-based regulation, more principles-based regulation (MPBR), 'light-touch' regulation, the enrolment of consumers into the regulatory process and the encouragement of firms to treat their customers fairly. Risk regulation deals with the management of regulatory or institutional risks for example risks that the regulator will not achieve its objectives as a result of the misbehaviour of the regulated firms (Black, 2005). This approach potentially gives the regulator very wide powers to do whatever is necessary to tackle any issues that arise which pose a risk to it attaining its objectives.

More principles-based regulation (MPBR) is based on greater reliance on outcomes-focused, broad rules (which are known as principles) and less reliance on detailed, specific rules (F.S.A, 2007a). The regulator uses eleven over-arching principles, which are of a highly general nature, and apply to all firms performing regulated

activities in the UK (FSA Handbook PRIN 1.1). They provide a general guide on how the regulated firms should behave, for example the sixth principle requires firms to pay regard to the interests of their customers and to treat them fairly (FSA Handbook PRIN 2.1.1). Apart from the principles, there is a second layer of rules, which are more detailed and which deal with specific matters, such as conduct of business and the persons subject to regulation under the regime. The principles and detailed rules represent a more interventionist approach to the protection of financial services consumers, and are therefore desirable. Prioritising the principles over the detailed rules is also desirable because they are broader in scope than the detailed rules.

The third key idea that has influenced the way in which the UK financial industry has been supervised is the idea of ‘light touch’ regulation. This is characterised by the implementation of the supervisory regime in a business-friendly manner. It is also characterised by reluctance, on the part of the regulator, to interfere with how firms conduct their business, for example reluctance to review firms’ business models or to take a tough stance with them. It is non-interventionist, and has been considered a key factor in the regulatory failings that contributed to the financial crisis (Sants, 2010). To this extent, it serves as a good illustration of how non-interventionist approaches fail to deliver on regulatory objectives such as the protection of consumers.

The enrolment of consumers into the regulatory process is another key idea that has influenced the regulator’s attitude to the supervision of UK financial services. Enrolment is the natural progression from decentred regulation, which is, in turn, based on the idea that governments do not have a monopoly on regulation, and that regulation occurs within and between other social actors with or without the

government's involvement or approval (Black, 2001). These other actors will be 'enrolled' into the regulatory process implicitly or explicitly, and will play a part in shaping the regulation. One group of such social actors is consumers, and they are enrolled into the regime based on the requirements that the regulator educates consumers (FSMA section 4) and encourages them to take responsibility for their decisions (FSMA section 2(3)(c)). Enrolment, therefore, embodies the notion of *caveat emptor* (Davies, 2000, Mcmeel and Virgo, 2001), and is therefore a non-interventionist approach to consumer protection. Applying *caveat emptor* to financial services supervision is problematic because it amounts to abandoning vulnerable consumers to their fate. If consumers suffer from cognitive biases, and need regulation in order to protect them, strategies of enrolment which make the consumers the *de facto* regulators ultimately do not make sense.

Encouraging firms to treat their customers fairly is another key idea in the supervision of UK financial services. This is done through the Treating Customers Fairly (TCF) initiative, which is largely based on the FSA's principles, particularly Principle 6, which requires firms to pay regard to the interests of their customers and to treat them fairly (FSA Handbook PRIN 2.1.1). Under the initiative the regulator set firms six outcomes to achieve in terms of consumer protection which include, for example, the suitability of advice provided to consumers and the provision of products and services to an acceptable standard (F.S.A, 2007b) . The TCF initiative aims to bring about positive changes in the way that financial firms treat their customers, thereby delivering better outcomes for consumers (Waters, 2006). This approach has been largely non-interventionist, with the regulator giving the regulated the tools to improve their approaches towards consumers but leaving the actual implementation of

such improvements to the firms and their senior managements (Wilson, 2007). Under such a non-interventionist approach the firms did make some progress but there is still considerable room for improvement (F.S.A, 2007c, Wilson, 2007). There is therefore much more to be done with regard to improving the way firms treat their customers.

CONSUMER PROTECTION IN THE FINANCIAL INDUSTRY AFTER THE CRISIS

The effects of the financial crisis have been felt in many parts of the world and have been very severe indeed. They have led to some substantial changes in the way the UK financial services industry is regulated, with potentially significant consequences for its consumers. The first change is a change in the FSA's philosophy and its approach to supervision. The second, and more significant change, is the UK coalition government's plan to put in place a new financial regulation regime, that will see the FSA phased out in 2012, and its functions carried out by the Bank of England and a number of new regulators. These two changes will now be discussed in some detail.

The change in the FSA's philosophy and approach to supervision

The FSA has carried out reviews looking into the causes of the crisis (F.S.A, 2008, Turner, 2009) and consultations on how to improve the regulation of UK financial services after the crisis (F.S.A, 2009, F.S.A, 2010). It has acknowledged the failure of its non-interventionist approaches, and has signalled its intention to change its approach to one that is more interventionist, intrusive and proactive (Sants, 2009). This involves some changes in its philosophy and its approach to supervision.

In its review of the supervision of Northern Rock it concluded that the way it implemented risk regulation may have been incorrect, but that risk regulation works in theory (F.S.A, 2008). The idea of risk regulation, therefore, remains key to its supervisory approach, with the regulator reiterating its stance that it is not feasible to try and prevent all failures (F.S.A, 2008). It will therefore continue to mitigate risks while at the same time fostering innovation and competition.

The idea of more principles-based regulation has been replaced with ‘outcomes-focused’ regulation. Although the principles have been left intact the approach towards their application is slightly different. Outcomes-focused regulation is centred on intervening in a proactive way, and judging the future decisions of firms based on business model and other analysis (Sants, 2010). This represents a more proactive and rigorous approach to supervision. It is interventionist and is, arguably, a better way to protect consumers.

The idea of ‘light touch’ regulation has probably been the biggest casualty of the financial crisis. It had already been criticised before the crisis, and is considered a key contributor to the regulatory failings that contributed to the crisis (Sants, 2010). As a result, the regulator has decided to do away with it, and to replace it with the idea of intensive supervision. Intensive supervision involves greater attention to consumer outcomes, as well as more intrusive inspections and mitigation of the risks inherent in firms’ business models (Sants, 2009). It also involves identifying and encouraging the right culture within the industry (Sants, 2009), thus showing that the regulator is beginning to understand how important it is that the culture of putting consumers first is encouraged. It also involves a greater willingness to take a tougher stance with

firms and to take enforcement action against them where appropriate. Intensive supervision is a very interventionist approach to supervision, and is beneficial to consumers because it puts their interests high up on the regulatory agenda.

Intensive supervision, however, does not fit in perfectly with the idea of enrolment of consumers into the regulatory process. Enrolment remains part of the regulator's overall supervisory strategy and is comprised of enlightening or empowering consumers, on the one hand, and *caveat emptor*, on the other hand. Although enlightened or empowered consumers will complement attempts to implement intensive supervision, the same cannot be said of *caveat emptor*. It is difficult to see how *caveat emptor* can be reconciled with intensive supervision. This means that there remains the potential for non-interventionist approaches, such as *caveat emptor*, to reduce the effectiveness of interventionist approaches.

The idea of Treating Customers Fairly remains firmly on the regulator's agenda for the supervision of firms. The regulator accepts that the TCF initiative has not delivered the outcomes that consumers deserve, largely as a result of its implementation in a non-interventionist, reactive manner (Sants, 2010, Sants, 2009). It has consulted on ways to improve professionalism within the industry (F.S.A, 2009) and the way firms handle consumer complaints (F.S.A, 2010). It has also re-focused the TCF initiative towards making the retail market work better for consumers, avoiding the crystallisation of conduct risks and delivering credible deterrence, and prompt and effective redress for consumers (Sants, 2010). This re-focusing represents a welcome shift away from non-interventionist approaches, and a desirable move towards interventionist approaches to consumer protection.

The new financial regulatory regime to replace the FSA

The coalition government in the UK has decided to get rid of the FSA and to split its responsibilities between the Bank of England and a new financial services consumer protection agency (currently being referred to as the Financial Conduct Authority (FCA)). In this new regime the Bank of England will be responsible for the overall financial stability of the UK financial system, in addition to its already existing responsibility for monetary policy. To help it with this, a new prudential supervisory body (currently being referred to as the Prudential Regulatory Authority (PRA)) will be created, which will be tasked with ensuring that banks and other financial services firms are financially sound (Masters, 2010, Osborne, 2010, Treasury, 2010). In addition, a new Financial Policy Committee (FPC) will also be created, with the remit to prevent dangerous build-ups of credit or asset bubbles in the economy (Osborne, 2010, Parker and Masters, 2010, Treasury, 2010).

The consumer protection responsibility of the FSA will be transferred to the new consumer protection agency, which will be tasked with regulating the conduct of all financial services firms (including how products and services are sold to consumers) (Ross, 2010) and ensuring the integrity of the UK's financial markets (Elliott, 2010).

An apparent advantage of this new institutional structure is that it brings the regulatory regime more in line with the 'Twin Peaks' model of financial regulation, advocated by Taylor (1995) and currently in use in Australia. This model is advantageous because it advocates putting one regulator in charge of prudential supervision and another in charge of regulating the business conduct of financial

firms, thus avoiding a situation where a regulator is confused as to which objective to prioritise (Taylor, 1995).

The second supposed advantage of the new institutional structure is that it satisfies the need to bridge the gap between macro-prudential policy, on the one hand, and micro-prudential policy, on the other hand (Elliott, 2010, King, 2010). This has been described as necessary because “monetary stability and financial stability are two sides of the same coin” (King, 2010).

There are, however, a number of criticisms that can be made of the new changes, even at this early stage. The first is that the changes do not address one of the most significant factors that must be taken into account in any attempt to improve financial regulation- the need for robust supervision and implementation of regulatory objectives. It can be argued that the institutional structure or organisational structure is only one factor in achieving good regulation, and that other potentially more important factors are the quality and ability of the regulator’s staff (Masters, 2010, Parker and Masters, 2010). Altering the institutional structure of the regulatory regime without addressing the fundamental problems of flawed regulatory philosophy and inadequate supervision by the regulator is unlikely to generate significant improvements in the regulation of UK financial services.

The second criticism relates to consumer protection in particular- the coalition government appears to have given very little consideration to how the new consumer protection agency will carry out its consumer protection functions. It has, for example, been argued that putting the market integrity responsibility alongside the

consumer protection function appears to be merely an afterthought (Parker and Masters, 2010), thus giving the impression that both consumer protection and maintaining market integrity are not considered, by the coalition government, to be as important as prudential supervision of the financial system.

The third criticism is that the coalition government has also failed to clarify what the regulatory philosophy of the new consumer protection agency will be- if it carries on with the FSA's new philosophy of intensive supervision then it will be more interventionist in its approach, and this will potentially be advantageous for consumers of UK financial products and services. If, on the other hand, it adopts neo-classical economic ideas that Conservative governments adopted in the past then it will rely on non-interventionist approaches such as information disclosure, *caveat emptor* and the promotion of competition, and this could potentially be disadvantageous for consumers of UK financial products and services.

CONCLUSION

This paper has examined the approaches to consumer protection in UK financial services. It has used the literature on Behavioural economics and Psychology as the basis for a critique of the UK's approach to consumer protection in the area of financial services. This literature shows that, contrary to the belief, in neo-classical economics, that people make rational choices, individuals in fact do not always make rational choices. The use of heuristics results in cognitive weaknesses in individuals' decision-making, leading them to make inferior decisions with regard to their welfare. This suggests that interventionist approaches to consumer protection are preferable to non-interventionist ones, because they take into account the fact that individuals'

decisions are not always rational or in their best interests. Other factors that support the argument that interventionist approaches are better than non-interventionist ones include the problem of information inadequacy, the existence of information asymmetry between sellers (suppliers) and buyers (consumers), the problem of lack of competition (among sellers or suppliers of financial services products) and the potential for fraud or deception.

The FSA has taken steps to improve its overall approach to supervision, and its approach to consumer protection has become more interventionist. The fact that the FSA will be replaced in the near future does, however, throw up questions regarding what the approach to consumer protection in UK financial services will be in the future. The failure of non-interventionist approaches in the recent past does, however, show that future efforts at consumer protection in financial services ought to be more interventionist in nature rather than non-interventionist.

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